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Date:
June 01, 2007

Legend:

Unitrust =

University =

Income Beneficiary =

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Dear :

This private letter ruling responds to your request dated October 22, 2003, supplemented by correspondence dated November 20, 2003, and May 5, 2004, for a ruling that a redemption of a limited purpose financial instrument ("unit") by Unitrust will generate short-term or long-term capital gain or loss to Unitrust, depending on the holding period of the unit.

FACTS

Unitrust is a charitable remainder unitrust that is intended to qualify under § 664(d). University is exempt under § 501 as an organization described in § 501(c)(3) and has been classified as an educational organization under §§ 509(a)(1) and 170(b)(1)(A)(ii).

University is the trustee of Unitrust, and as trustee, University holds legal title to Unitrust's assets. In addition, University has the charitable remainder interest in Unitrust. Unitrust's terms provide that it is a trust from which x% of the net fair market value of its assets, valued annually, is to be paid annually to Income Beneficiary.

University owns a number of investment assets outright (the Endowment). The Endowment consists of a wide variety of assets, including public equities, bonds, private equity, and real estate.

University (in its capacity as owner of the Endowment) will enter into a contract with itself (in its capacity as trustee of Unitrust) providing that in exchange for Unitrust's assets, University will issue Endowment "units" to Unitrust. The price of a unit will equal its value on the date of transfer to Unitrust, as determined under the terms of the contract. The contract provides that the value of the unit is based on the value of the Endowment divided by the number of the units outstanding, and is set monthly by University. University represents that it uses the unit as an internal accounting device to distribute funds from the endowment to University's various departments and schools, each department or school owning a certain number of endowment units and receiving quarterly distributions based on the number of units owned.

The contract provides that ownership of a unit entitles Unitrust to quarterly "income payouts" based on the number of units owned on the payout date. The payout rate is set by University to avoid the impact of fluctuations in the market, thus providing a predictable disbursement of money to unit holders. Therefore, the payout rate is not directly tied to investment performance. University's governing body has the final authority to fix each year's payout rate.

The quarterly income payout is calculated in two steps: First, unit value is multiplied by the payout rate set by University (in its capacity as the owner of the Endowment). Second, the product is multiplied by the number of units held by Unitrust. The final product is the payout to which Unitrust is entitled.

Unitrust may invest any or all of its income payout in additional units. The contract also provides that units may be redeemed by Unitrust. A redemption might occur, for instance, if Unitrust needs additional cash to meet its income requirements with respect to Income Beneficiary. In a redemption, Unitrust will transfer one or more units to University and receive in return the amount of cash equal to the number of units transferred multiplied by unit value as of the date of the redemption.

The contract provides that University neither reserves nor segregates any part of its endowment earnings from inclusion in the value of the unit. The contract further provides that Unitrust has no ownership interest in the underlying assets of the endowment, and University is neither a partner nor an agent of Unitrust. In addition, the contract provides that Unitrust has no power or right of any kind to control, direct,

supervise, recommend or review University's business activities, operations, or decisions with respect to the endowment, except that Unitrust has the right to review the payout computation. Lastly, the contract provides that Unitrust will never be or become liable for any cost, expense, or payment incurred or due by University or for which University is liable or responsible relating to the Endowment, and University will indemnify and hold Unitrust harmless from and against any liability arising out of any action or inaction by University with respect to the Endowment.

Unitrust and University will treat income payouts as ordinary income, and the holding period of a particular unit as beginning on the date the unit is issued to Unitrust.

University represents that any Endowment investment return over and above the annual payout rate is credited to the principal amount of the Endowment and is reflected in an increase in the value of each unit outstanding. Similarly, if the annual payout rate exceeds the earnings on the Endowment, the value of each unit outstanding will decrease in value.

A private letter ruling was previously issued to Unitrust concluding that the issuance of units, the making or receipt of payments with respect to the units, and the holding or redemption of units, will not generate unrelated business taxable income under § 512(a)(1) to Unitrust.

LAW AND ANALYSIS

Section 1222 provides that capital gain or loss is generated upon a sale or exchange of a capital asset. Section 1234A provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

Section 1221 defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of eight listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in § 167, or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; (5) certain publications of the United States Government; (6) certain commodities financial derivatives; (7) certain hedging transactions; and (8) supplies of a type regularly consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

In the present case, none of the listed exceptions in § 1221 applies. However, although § 1221 appears to give broad meaning to the term capital asset, the Supreme Court has found it "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of § 1221] qualifies as a capital asset;"

rather, “the term ‘capital asset’ is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time” Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960) (citing Burnet v. Harmel, 287 U.S. 103 (1932)). Accordingly, the Court has held that certain interests that are concededly “property” in the ordinary sense are not capital assets.

On this basis, capital gain treatment has been denied for transactions involving payments in return for interests carved out of, or related to, an interest retained by the taxpayer. See, e.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (Court denied capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas interests); Hort v. Commissioner, 313 U.S. 28 (1958) (Court denied capital gain treatment on the disposition of a term of years carved out from a fee simple).

The Court also has denied capital gain treatment for transactions on the basis that the payments at issue were a substitute for ordinary income. In Hort, for example, the taxpayer inherited a building, and one of the tenants canceled its lease, paying the taxpayer a cancellation fee. The Court held that the cancellation fee was ordinary income because the cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Id. at 32. The Court bolstered this “substitute-for-ordinary-income” doctrine in P.G. Lake, stating, “The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income.” P.G. Lake, 356 U.S. at 265.

Consistent with the substitute-for-ordinary-income doctrine, the courts have denied capital gain treatment for transactions involving interests related to compensation for past or future personal services. See, e.g., Freese v. United States, 455 F.2d 1146 (10th Cir. 1972) (lump sum representing unpaid commissions due under an employment contract); Elliot v. United States, 431 F.2d 1149 (10th Cir. 1970) (lump sum paid for the surrender of right to future sales commissions); Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (payment for interest in films to be produced by taxpayer). Similarly, courts have denied capital gain treatment for interests relating to income already earned or about to be earned. See, e.g., United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (earned original issue discount); Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006) (lump sum payment for annual installments of lottery prize); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (right to dividend that was already declared).

On the other hand, as the courts have noted, “Simply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income.” Guggenheim v. Commissioner, 46 T.C. 559, 569 (1966). In Guggenheim, the court focused on whether

the taxpayer transferred substantial investment risks in the sale of undivided interests in a stallion. In that case, the court noted that if the value of the stallion subsequently increased, the taxpayer would not share in that increase with regard to the interests transferred. Instead, the new owners received all the benefits of an increase in value of the stallion, and all the burdens of a decrease in value. Thus, the court found that the taxpayer had transferred substantial investment risks and was entitled to capital gain treatment on the sale of the interests.

In United States v. Dresser Industries, Inc., 324 F.2d. 56 (5th Cir. 1963), the court distinguished between proceeds from the present sale of the future right to earn income, which is capital gain, and the present sale of the future right to earned income, which is ordinary income. Id. at 59. In that case, the court found that the sale of an income-producing asset was not merely the sale of the right to income already earned; instead, the taxpayer had an asset that would produce income in the future. Thus, the court held that the taxpayer's sale of the asset generated capital gain. Id. Similarly, in Commissioner v. Ferrer, 304 F.2d. 125 (2d Cir. 1962), the court held that the taxpayer's surrender of a lease of a play constituted the sale or exchange of a capital asset, despite the fact that receipts from the play would have been ordinary income. Ferrer at 132. In its rejection of the government's argument against capital gain treatment, the court noted that there was no equivalence between amounts paid for the surrender of the lease and the income that would have been realized by its retention. Id. at 133.

With respect to the proper characterization under § 1221 of the unit, the bundle of contract rights represented by each unit is property, and may be treated as a capital asset for purposes of § 1221. The most important characteristic of the unit is that significant investment risks are associated with, and included in, each unit. With respect to each unit there is an opportunity for appreciation as well as a risk of loss. Each unit represents a substantial investment by Unitrust, and each unit has an ascertainable basis. The value of each unit is directly tied to the Endowment's investment performance; poor performance will detract from the value of a unit, while performance above the payout rate set by University will increase the value of each unit. The opportunity for appreciation, risk of loss, and basis in each unit are characteristics similar to other contract rights that are treated as capital assets (for example, other financial derivatives, notional principal contracts, mutual fund shares, or corporate stock). Further, the benefits and burdens associated with each unit are similar to those associated with the property held to be capital assets in Guggenheim, Dresser, and Ferrer.

In addition, although Unitrust will receive ordinary income in the form of the quarterly payouts that are based in part upon the number of units owned by Unitrust, consideration received upon a redemption of a unit is not a substitute for what would otherwise be received as an ordinary income payout, whether due and payable or about to be due and payable to Unitrust under the terms of the contract. Rather, the amount paid for a unit upon a redemption is equal to the value of the unit on the date of

redemption. Unit value on any given date is equal to overall asset value of the Endowment divided by the number of units outstanding. In addition, the unit is not an interest related to compensation for past or future personal services. Instead, the unit is an asset that will produce income in the future.

Finally, the unit does not represent a carve-out of a larger estate retained by Unitrust. The appreciation of each unit is attributable to overall Endowment property appreciation, much of which, in turn, is attributable to increases in the value of capital assets in the Endowment. The contract provides specifically that Unitrust does not have any ownership interest or rights to the Endowment.

We conclude that the unit is a capital asset for purposes of § 1221. Furthermore, § 1234A will apply to treat gain or loss from the cancellation, lapse, expiration, or other termination of the unit as gain or loss from the sale of a capital asset. Thus, in general, the redemption of the unit by Unitrust will generate short-term or long-term capital gain or loss to Unitrust, depending on the holding period of the unit.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Tom Moffitt
Chief, Branch 2
(Income Tax & Accounting)